Special Market Report
A Look at Recent Geopolitical Tensions

At the time of writing, Russia's insurgence into Ukraine has intensified well beyond the two initial pro-separatist areas in the Donbas region (i.e., Donetsk and Luhansk). Despite the unified sanctions from around the world, Russia is not stopping in their attempt to capture the capital of Ukraine and threaten the entire sovereignty of the country. Not only are people from around the world witnessing the destruction of a war unfolding through cell phones and social media but trying to make sense of the violent daily moves in the equity, bond and commodities markets is unnerving as well.

In this white paper we will not be political analysts. We will not try to predict how far Putin will take this insurgence or speculate about future events that are rumored inevitable because of Russia's unjustified invasion (e.g., China/Taiwan). Instead, we will focus on the facts about the current event and what it means for our base case scenario for economic growth, the Federal Reserve, and our asset allocation.

The motive behind invading Ukraine

Russia has long desired to reunite the Soviet Union as it has been threatened by the expansion of the NATO alliance throughout Europe. The NATO alliance is a group of 30 countries (at present) across North America and Europe that has established a militarily and political union. In essence, an attack on one country is considered an attack on all the NATO members. It would result in a unified political and/or military reaction from NATO members. For further context, the last time NATO's Article 5 was invoked was the 9/11 attacks on the U.S. [1]

Russia's resentment for the West and NATO has deep roots that stem back to the fall of the Soviet Union. Russia has been bitter as leaders have watched countries that were once under Soviet control and that border Russia declaring their independence and one by one joining the NATO alliance (i.e., Estonia, Lithuania, Latvia in 2004). Ukraine and Belarus are two countries that have generally

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been allies of Russia and even established governments that were pro-Putin. However, after Russia's unjust annexation of Crimea (in 2014) the Ukrainian government expressed its desire to join the NATO alliance. Ongoing corruption and prior Ukrainian government's Russian ties ultimately led to the election of Voldodymyr Zelensky in 2019. Zelensky won by a landslide as citizens of Ukraine welcomed his anti-corruption campaign and his lack of being entwined in crooked political circles. As a result, the relationship between Ukraine and Russia began to collapse.

The world unites with sanctions

Aside from the overwhelming outpouring of support from the world for Ukraine, its army, and its citizens, the world has united to levy sanctions on Russia that have put the country on the same pariah list as countries like North Korea, Iran, Cuba, and Syria.

Sanctions have not stopped at the government level. To further illustrate the world's support for Ukraine, businesses and sports organizations around the world have unified in banishing Russia. Fifa and Uefa have suspended Russia sports teams, the Uefa Championship game was removed from Russia and all Formula 1 and World Cup skiing events have been banned from Russia. In addition, oil behemoths like BP, Exxon and Shell have abandoned energy projects with Russia despite taking a hit on their bottom lines.

The sanction list is long, it has been growing day by day and includes (but is not limited to):

- Sanctions against the Russian Central Bank include freezing their international reserves and banning them from any transaction in U.S. dollars and other world currencies.
- Halting work on the Nord Stream Pipeline (a major natural gas pipeline between Russia and Germany).
- Freezing assets and mobility of Russia's wealthiest citizens (Oligarchs) including yachts, real estate, and luxury vehicles.
- Cutting a wide range of Russian banks from using the SWIFT international payment system (i.e., Society for Worldwide Interbank Financial Telecommunications).[2]
- Banning Russian companies from international sovereign and corporate debt markets.
- Limiting and/or banning key exports to Russia such as airplane parts, semiconductors, smart phones, and computers.
- Prohibiting Russian jets and airlines from entering U.S., EU, and UK airspace.
- Similar sanctions have been placed on Belarus for supporting Russia's attack.

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What will sanctions do to Russia?

Sanctions have historically been met with mixed opinions amongst political leaders as to their effectiveness. However, it is the first line of defense in trying to reign in an unjustified military operation. For those not familiar with the severity of some of these sanctions, they are deep and will likely have a detrimental impact on the Russian economy. The sanctions are ultimately isolating Russia from working in international currencies, global equity, and debt markets, severely restricting the flow of capital, and ousting the wealthiest Russians from the rest of the world, many of whom have enjoyed the privilege of multiple visas. The sanctions thus far have caused Russia's currency (the Russian Ruble) to fall to a record low and is now worth less than a penny versus the U.S. dollar. Their central bank has been forced to intervene to stabilize the banking system, but the most recent sanctions are limiting the Bank's ability to stem a collapse. The Russian Stock Exchange (the MOEX Index) has closed for multiple days after experiencing losses of more than 50%. **(Chart 1).** The debt of the sovereign nation is basically worthless, and the run on Russian banks has begun. Unfortunately, whether it is because some of these sanctions are just beginning to be felt, or some will not immediately be felt or perhaps that Putin falsely believes he has enough reserves to withstand the sanctions, he has not stepped back from his aggression against Ukraine.

Chart 1

Russia Equity Markets Deteriorate

Estimate Data as of February 25, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Past performance is not indicative of future returns

What does the conflict mean for global growth?

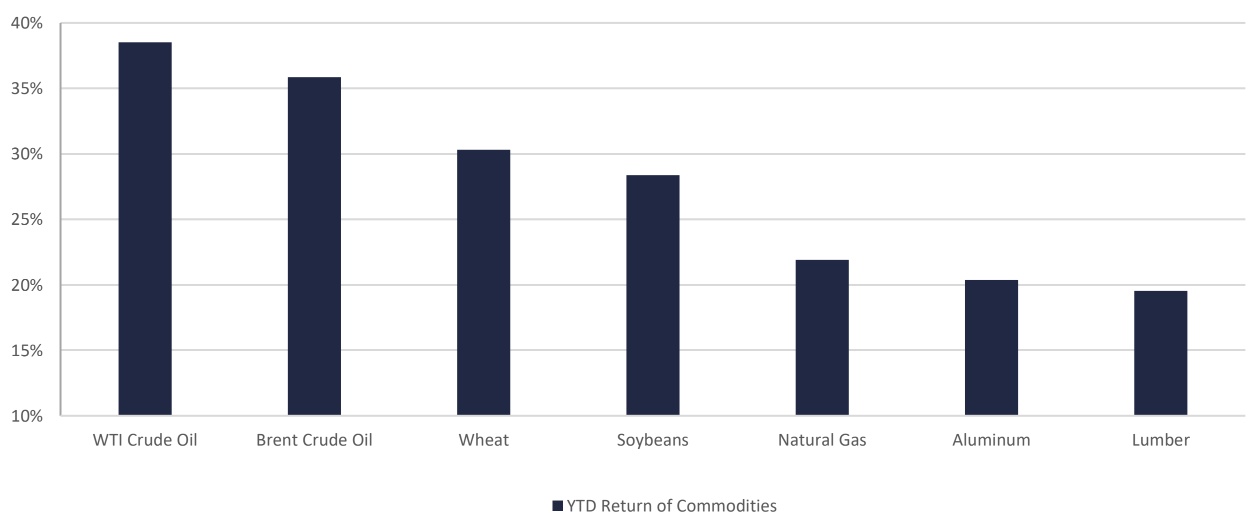
Different areas of the world will be impacted by differing degrees due to the recent geopolitical instability and global sanctions. Trade between Russia and the rest of the world outside of energy is relatively small (as a percent of world trade); nonetheless select countries will be more impacted by the isolation of Russian banks and businesses than others. Russia's biggest contribution to the world is energy. As of now, the energy sector in Russia has escaped most sanctions, so energy is still flowing to its biggest trading partners which includes Europe. However, that has not stopped a surge in energy prices and other commodities that are heavily exported from Ukraine and Russia (e.g., wheat). **(Chart 2).**

This will impact consumers around the world through testing sentiment and reducing spending power. The degree of its impact will depend on how long energy prices sustain elevated levels and what future actions, if any, will be taken against Russia's energy exports. This inevitably will result in some reduction in GDP, not just in the U.S. but also internationally. Those regions where consumers spend more of their disposable income on commodity related products will be impacted more (e.g., emerging market countries) as will those that rely on Russia for select trade (e.g., Europe and its energy dependency). However, it is important to remember that before the crisis unfolded the pace of economic growth in the U.S. and internationally was expected to be robust. Therefore, these economies can withstand some degree of reduction in GDP without causing an immediate recession. Within

Chart 2

Commodities Surge on Tensions

Data as of March 1, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.



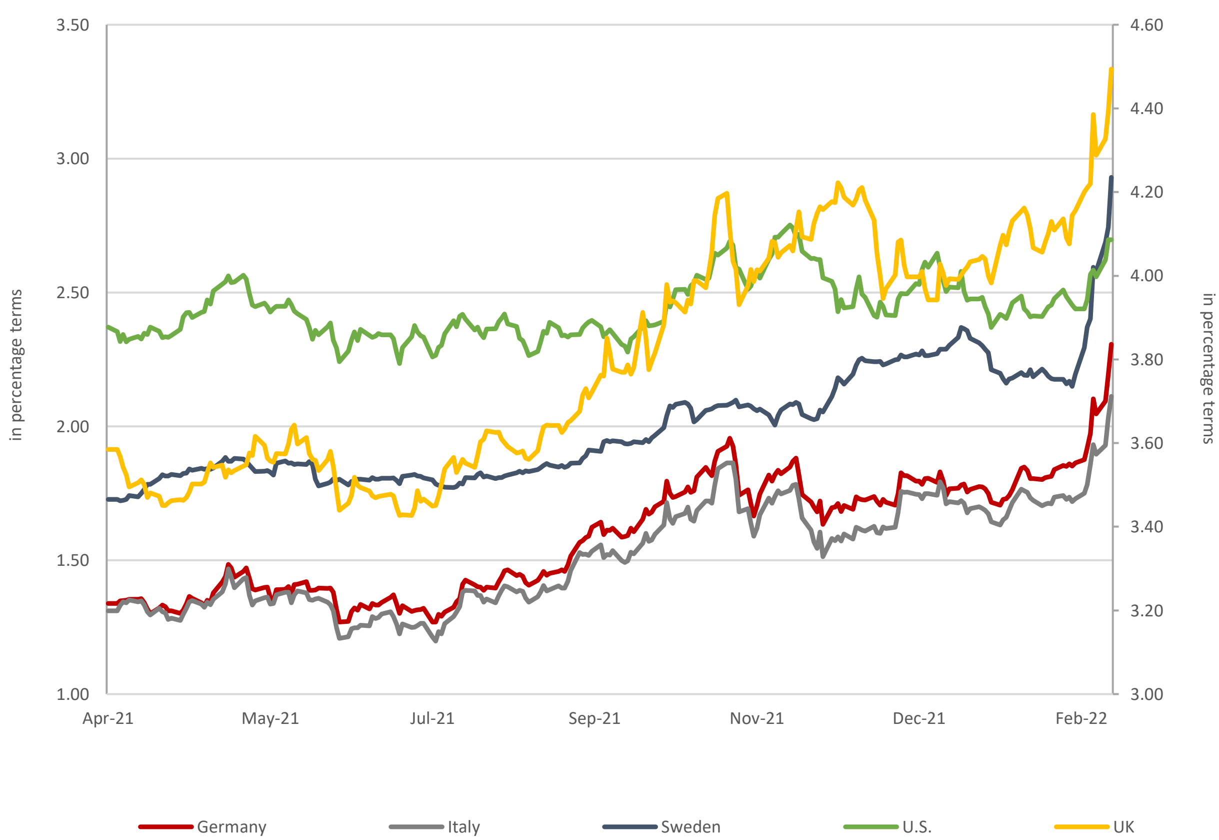
the U.S., the consumer balance sheet remains strong with net worth at a record high, wages are rising, and Americans are coming back to the labor force. Unfortunately, the impact will be greater for lower income households who spend a larger portion of disposable income on food and energy.

The surge in commodity prices will also impact inflation. Inflation was a problem before Russia's insurgence and will continue to be an issue through 2022 at a minimum, especially as commodity prices remain elevated. Inflation expectations around the world increased as the invasion started. **(Chart 3).** In addition, any further disruptions to the supply chain can also exacerbate the inflation dilemma.

Chart 3

Global Inflation Expectations Surging

Data is 10YR inflation breakeven rates by country as of March 2, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Will geopolitics change the central bank course?

The Federal Reserve is unlikely to change its course due to geopolitical events beyond their control. Instead, the Fed will focus on its dual mandate, maximum employment, and price stability. The one impact the turmoil may have on the Fed is to give them the ability to raise rates gradually and not deliver a shock and awe rate hike to the markets in March (25 bps instead of 50 bps). An aggressive initial hike was priced in before the invasion. A gradual approach can let them evaluate the impact to economic growth of sanctions and ongoing geopolitical turmoil as 2022 unfolds. We do not rule out a more aggressive approach later this year or in 2023 as we move past the current market instability and the Fed assesses the inflation environment.

This may alter the timeline of the European Central Bank as Europe's economy is much more reliant on Russia through energy commodities and its proximity than other developed economies. However, we believe it may just push the inevitability of rate hikes to 2023.

View on asset allocation given current geopolitical events

We are regularly monitoring all our portfolios and assessing the environment in relation to each client's risk tolerance. The first question we ask ourselves in times of exogenous events that fuel unnerving levels of volatility is if it has changed our fundamental outlook for economic growth and corporate earnings. The answer is no. We are maintaining our long-term outlook for portfolios (18-24 months) and believe that the situation between Russia and Ukraine will not have a lasting impact on our long-term outlook. In fact, history suggests these geopolitical events tend to be short lived and often present buying opportunities for equity investors. The only change to our view on global growth because of Russia is that the level of growth may not be as high as was expected coming into 2022 but we are not calling for a recession. Therefore, our constructive outlook for equities remains intact. While select sectors may benefit (e.g., energy, defense, industrials) from the turmoil in the short run at the expense of others (e.g., consumer discretionary) we do not believe this will have a long-lasting impact on overall corporate earnings.

What the last few weeks can remind investors is the importance of a well-diversified portfolio. Bonds, which have been an unloved investment in 2021 through early 2022, have served their purpose as a portfolio diversifier. In addition, having a well-diversified allocation across equity regions and equity styles has cushioned the losses in portfolios. What recent market moves have also taught investors is the dangers of letting emotions take over reason and locking in losses at times of high volatility. Keep in mind, volatility can move both ways. In recent weeks we have seen deep daily losses in equities and then tremendous daily rebounds that an investor would have missed out on if they sold when the market was down. Trying to trade around daily market moves, especially in this environment is risky and can threaten long term investment success.

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Our View

While we cannot predict how and when this will end, we do know that the world is taking one of the most unified approaches against an aggressor that we have seen since World War II. The sanctions are starting to work and will have crippling effects on the Russian economy and its citizens. We have seen governments outside of NATO join in the sanctions (even neutral Switzerland has joined in sanctions against Russia), more countries are expressing their desire to be part of NATO, and businesses and sports organizations are joining in abandoning all affiliations with the country. In addition, the bravery of the Ukrainians is inspiring and unifying not just the American people but citizens around the world.

From an investment perspective, we expect markets to remain volatile in the near term as investors assess the impact of sanctions and, elevated commodity prices and adjust to what may potentially be a different looking Eastern Europe in future years. We sympathize with investors that it is a difficult time to watch from a humanitarian perspective and then digest the brutal swings in your investment portfolios. We are here regularly monitoring the geopolitical situation and what it means for client's portfolios, especially if something happens that would change our base case scenario (which we do not see now). We are consistently monitoring what we own and making sure our allocations are in align with our views while mitigating risk.

We will continue to inform you of any changes that we see necessary. As always if you have any questions, please feel free to reach out to your Financial Advisor.

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1. https://www.nato.int/nato-welcome/index.html
2. SWIFT is an international communication network that offers the ability for banks and businesses to transact electronically for payments across many facets of the economy (including oil and gas). https://www.theguardian.com/world/2022/feb/28/what-sanctions-imposed-on-russia-over-ukraine-invasion-putin